NBAD

From West to East

Weekly Investment View

29th September, 2016

Politicians take the baton from the central banks

Last week markets were focused on the first US Presidential debate between Hillary Clinton and Donald Trump, which drew a record audience for such a televised debate. The occasion reminded one of sparring adversaries at a Roman amphitheatre. NBC network's Lester Holt moderated, and each candidate was keen to reinforce their diametrically-opposed views. Clinton and Trump traded heated exchanges (at times) on the subject of the US economy, foreign policy, and various domestic issues. There was a clear disconnect in not only the thinking of both candidates, but also the approach used by each to put across their points of view. Both sides predictably claimed victory after the debate, although the media and markets suggested Clinton had the upper hand. She was perceived as being calmer, and more balanced and presidential, compared to the high-toned, brash oratory of Trump. The apparent small 'win' by Clinton saw markets rally after the uncertainty in the days beforehand. The US dollar steadied. US data releases during the week were a net positive, with new home sales, durable goods orders, and US consumer confidence data all beating expectations, with the latter registering its highest reading since the summer of 2007. This led to speculation on US interest rates with several members of the US federal reserve calling for the rate hike sooner than later. US stocks rose, with the S&P 500 having risen by 0.6% so far this week. The Dollar Index remains range-bound, while US Treasury securities have found more stability with the 10-year yield trading back down towards 1.56%.

'US electioneering is truly underway; markets will be volatile'

Last week a skeptical crude oil market saw gains evaporate after OPEC members pointed to no production cuts ahead of the informal meeting that took place in Algiers last night. However, markets started to focus on a Saudi Arabian production freeze. What transpired from the meeting was a surprise production cut being announced by the group. Last night, OPEC in principle agreed an output ceiling of 32.5 million barrels/day, vs. the current 33 million barrels, the first of its kind by OPEC in nearly eight years. Saudi Arabia agreed to a new target of 10.145 million barrels/day of production, compared with 10.29 million previously. This has come only a day after the Kingdom announced sweeping cuts in public sector pay through bonuses and other benefits. Venezuela and Iran have been most vocal at OPEC about wanting to see oil production cuts. The two countries met last month ahead of this meeting and had talked to the Saudis in what appeared to be a non-committal agreement at the time. This may have been the trigger to last night's decision for a cut.

The oil-producing economies of OPEC have really been battered by the collapse of crude oil prices. Widening budget deficits, cuts in government spending, and a re-think on capital expenditure by the world's national oil companies have all taken their toll. Iran, however, has been keen to 'make up for lost time' after US sanctions were lifted on the country earlier in the year. Production was ramped-up to raise revenues in the investment-starved country. More recently, the oversupply by OPEC overall had made Iran rethink its 'over-production to catch up' strategy. The meeting in Algiers last night was initially viewed as less important than the formal OPEC meeting due on 30th November. The unexpected news last night saw oil markets receive a nice lift, with WTI trading at $47 a barrel, up 3%. US inventories remain stubbornly high, though, with the US fracking industry clearly not cut back in the way that the Saudis had hoped for.

'Note that hedge funds are net short in oil should they cover…'

Significantly for the oil markets, hedge funds have been positioned 'net-short' for most of

Claude-Henri Chavanon

Managing Director
Head of Global Asset Management

the year. Continued disappointment has been the norm for oil bulls who expected higher prices before now. Last night's developments, however, likely signal that Saudi Arabia finally appears to be feeling the pain from its unilateral strategy of taking on the US oil industry. It comes at a dangerous time for Riyadh, with US Congress (largely Republican, and pro-US oil companies) vetoing President Obama's overturning of legislation allowing the families of 9/11 victims to sue Saudi Arabia. The Tadawul share index has tumbled over 7% in the last couple of days as relations between the two countries have deteriorated. Saudi Arabia has remained very much an ally of the US, and is a key coalition partner with the UAE facing Al-Qaeda and Iranian-backed Huthi rebels in Yemen. We think the Algiers announcement paves the way to stabilizing crude oil markets for the longer term. A decision viewed as piecemeal is nonetheless a step in the right direction, especially if successfully implemented. **We reaffirm our target price range of $40-$55 (basis WTI), with the growing likelihood of $60 sometime in the first half of 2017. Accordingly we continue advocating taking long positions in oil-related assets into any weakness. Increasing exposure in**

markets such as MENA equities would clearly be one way of playing it.

MENA new bond issuance continued at a healthy pace this week, with the re-tap by Oman sovereign in the 3.625% 2021, 5-year bond, as well as the 4.75% 2026, 10-year issue. $1.5 billion was issued in total after books were oversubscribed several times in the state. Oman re-tapped $500 million in the 5-year and $1 billion in the 10-year tranche. Yesterday, Union National Bank of Abu Dhabi priced a $600 million senior unsecured 5-year bond issue at 170 basis points over the US 5-year swap at a price of 99.592 (for a yield to maturity of 2.838%), also well received by the market with books being oversubscribed. Bahrain sovereign is set to roadshow globally in the coming week with a possible transaction to follow. The markets of course await Saudi Arabia's first sovereign deal, expected sometime in October. Some commentators have said this could now be under threat after the US Congress veto move mentioned above.

'Sterling is weathering talk of a harder Brexit'

In recent days there has been increased talk of a 'hard' Brexit for the UK, as remaining EU members large and small have voiced concerns that the UK cannot 'have its cake and eat it', with other quotes referring to an increasing likelihood of a 'clean break' divorce (as opposed to one that is left with various financial and other arrangements in place). The mood is that the UK will not be allowed any kind of 'favoured non-member status', and that any imposed rules by the UK regarding tighter immigration will be a direct trade-off against access to the single market. The ongoing members want to dissuade others from leaving, and avoid the financial consequences such events might have. The Brexit discussions, set to accelerate early next year, are going to be complex, and British Prime Minister Teresa May and her team will have their work cut out to make a success of them – but we believe they will. A difficult exit for the UK is in no one's interests. Our upcoming 'Investment Outlook 2017' will be featuring this subject in depth. In the meantime, sterling has a solid look about it at or slightly below $1.30. **Although uncertainties remain, the market probably did a good job of almost 'instantly discounting' much of the ultimate risk in marking the currency pair down from $1.4877 to $1.2931 almost in a straight line.**

Deutsche Bank is a very important bank, being Germany's largest lender, it has a special place in that country's economic system, and is up there with the 'big boys' globally. So when its stock price plummeted 7.5% one day last week, the markets took note. The imposition of a $14 billion fine by US regulatory authorities for alleged mortgage-backed security mis-selling is just one factor that has forced DB's stock price to an estimated 25% of its book value. The German government in no way wants to be seen as being willing to bail DB out should that actually be necessary. This all ties in with the ongoing discussion about (in this case) the ECB's monetary accommodation, due to come to an end next March. Mario Draghi, President of the ECB, has said that weaknesses in Eurozone banks cannot be simply put down to low interest rates. The 10-year German Bund yield has in recent days once again fallen sharply from just above zero, to -0.195%. **We cannot but help think that the end-game in eurozone negative rates is being played-out.**

'Base metals are close to an upside break-out'

Last week we said that our Asset Allocation Committee had decided to move to an overweight in precious metals through gold, given the seeming growing need for an effective hedge against unforeseen economic and market circumstances that could be triggered by a US election win for Trump or perhaps more ramifications to come with Deutsche Bank? It is worth mentioning that silver is another - albeit more volatile than gold - way of investing in precious metals, whether it be for hedging or trading purposes. Quoted at $19.15, silver has been identified by some as a classic commodity bull market, following its break-out from a $14-18/oz trading range. In reality, 50% of silver demand is for industrial purposes, yet the price tends to move in a levered manner as investment interest builds, and that appears to be what is happening. So although being regarded as a precious metal, it has base metal attributes. **In that connection, we note that the London Metal Exchange Metals Index is very close to an upside break-out while viewing such a play as protection against volatility in markets that the AA committee of NBAD is concerned with.**

This weekend the Chinese yuan will be joining the exclusive IMF 'SDR' (Special Drawing Rights') club, alongside the dollar, the euro, the yen, and sterling. Our readers will know we have been flagging this some months, and the likely significance of this for the internationalization of the yuan, and for Chinese asset values. SDRs are a unit of account facilitating access to members' currencies. Nothing will change dramatically overnight, yet SDR entry for the yuan will usher-in some pressure for central banks to begin to diversify their foreign exchange reserves, which are currently about 64% in dollars. **Although the larger China discussion is still dominated by its internal debt, global investors will have to increasingly take note that the Chinese have now really 'arrived' - and its investment opportunities simply have to be accessed.**

For any inquiries related to this article, please contact Alain.Marckus@nbad.com or Clint.Dove@nbad.com

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